In The

Supreme Court of The United States

October Term, 1977

No. 77-1820

Interstate Natural Gas Association of America and Texas Eastern Transmission Corporation,
Petitioners,

v.

Federal Energy Regulatory Commission,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

Jerome J. McGrath
John H. Cheatham III
1660 L Street, N.W.
Washington, D. C. 20036

Attorneys for Interstate Natural Gas Association of America

James W. McCartney
Judy M. Johnson
2100 First City National Bank Bldg.
Houston, Texas 77002

Attorneys for Texas Eastern Transmission Corporation

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

The Interstate Natural Gas Association of America (INGAA) and Texas Eastern Transmission Corporation (Texas Eastern)[1] hereby petition for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the District of Columbia Circuit entered in this case on March 28, 1978.

[1] INGAA is a non-profit national trade association whose membership includes virtually all of the major interstate pipeline companies subject to the jurisdiction of the Federal Energy Regulatory Commission under the Natural Gas Act, 15 U.S.C. § 717, *et. seq.* Texas Eastern is an interstate pipeline company (and a member of INGAA).

OPINIONS BELOW

The Memorandum Opinion of the Court of Appeals for the District of Columbia Circuit remanding the case to the Federal Power Commission for further proceedings and the final judgment of the court on review of the outcome of the remanded proceedings, not yet reported and not to be officially published, are printed in the Appendix (pp. 98-108 and 121-22) filed with this Petition. The opinions and orders of the Federal Power Commission and its successor, Federal Energy Regulatory Commission[2] are styled Order No. 505, 51 FPC 714 (1974), Order No. 505-A, 51 FPC 832 (1974), Order Denying Rehearing and Reconsideration, 51 FPC 1746 (1974), Order No. 505-B, issued July 8, 1977 in Docket No. R-424, and Order Denying Application For Rehearing of Order No. 505-B, issued September 7, 1977. The latter two Orders have not been officially reported. These opinions and orders are printed in the Appendix filed concurrently herewith at pp. 1-77, 84-88, 89-96, 108-18 and 119-20, respectively.

JURISDICTION

The judgment of the Court of Appeals for the District of Columbia Circuit was entered on March 28, 1978. The

[2] On September 30, 1977, pursuant to the provisions of the Department of Energy Organization Act, Public Law 95-91, 42 U.S.C. § 7101 (Aug. 4, 1977), and Executive Order No. 12009, 42 Fed. Reg. 46267 (Sept. 13, 1977), the Federal Power Commission (FPC) ceased to exist and most of its functions and regulatory responsibilities were transferred to the Federal Energy Regulatory Commission (FERC), which, as an independent Commission within the Department of Energy, was activated on October 1, 1977. Section 705(e) of the Organization Act, 42 U.S.C. § 7295, provides for the substitution of the FERC for the FPC as party-respondent in cases such as this. For the purposes of this brief, the term "Commission" when used in the context of an action taken or statement made prior to October 1, 1977, refers to the FPC; when used otherwise, the reference is to the FERC.

jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b).

QUESTION PRESENTED

Whether Commission Order Nos. 505, 505-A and 505-B, requiring regulated utilities to deviate from generally accepted accounting principles in reporting gains on reacquired securities are arbitrary and capricious, there being no ascertainable regulatory advantage to offset the added costs to the utilities and their consumers.

STATUTES INVOLVED

Involved are Sections 8, 16, and 19(b) of the Natural Gas Act, 15 U.S.C. §§ 717g(a), 717o, and 717r(b). These are set forth in the Appendix (pp. 123-25) to this Petition.

STATEMENT

This case does not involve rates or ratemaking principles except as the orders under review exert an *upward* pressure on capital costs and thus rates. Involved here is the Commission's requirement that the utilities depart from generally accepted accounting principles and amortize gains on reacquired securities over the remaining life of the issue (see Accounting Practices Board Opinion 26, issued October, 1972). This produces lower reported income and unnecessarily impairs the utilities' ability to attract capital.

Generally, when current interest rates are higher than those provided in outstanding securities, a company is able to repurchase such securities at a discount and to utilize the repurchased security to satisfy sinking fund requirements. As the repurchase transaction satisfies an obligation at an expenditure less than the face amount of

the obligation, generally accepted accounting principles provide for the entire gain being reflected as income in the year of the transaction. This had also been the Commission's position for the approximately thirty year period since the adoption of its Uniform System of Accounts.

In 1970, the Commission determined, in *Manufacturers Light and Heat Co., et al,* 44 FPC 314 (1970) that for rate purposes gains on reacquired securities could be normalized by amortizing the gain over the remaining life of the security.[3]

Thereafter, on August 6, 1971 the Commission issued a notice of proposed rulemaking entitled "Accounting For Premium, Discount And Expense Of An Issue, Gains And Losses On Refunding, And Reacquisition Of Long-Term Debt, And Interperiod Allocation Of Income Taxes" in Docket No. R-424. The rulemaking was instituted, *inter alia,* to promulgate new accounting methods for gains and losses on reacquired debt when no refunding is involved.

Despite comments almost universally opposing the proposed accounting change,[4] the Commission issued Orders

[3] The issue in *Manufacturers* involved the computation of Manufacturer's cost of debt capital. This is one of many factors, most of which are judgmental, taken into account in determining an appropriate rate of return (see Memorandum Op., App. 103-04).

[4] The New York Public Service Commission argued that the rule was "not necessary" and that it had "no support in generally accepted accounting principles" Comments of State of New York PSC (App. 131-32). The State of Wisconsin Public Service Commission commented that the proposal was "inconsistent with just and reasonable accounting provisions for public utility enterprises [and] inconsistent with the generally accepted accounting principles . . ." It characterized it as "unnecessary as well as being incorrect". Comments of State of Wisconsin PSC (App. 126-27). The State of California likewise asserted that the proposal was "in conflict with generally accepted accounting principles" Comments of State of California (App. 127-31).

505, 505-A, and an Order Denying Rehearing and Reconsideration requiring that jurisdictional utilities use accounting procedures which would track the Commission's rate treatment of gains from reacquired debt stated in *Manufacturers,* i.e., required amortization. The only rationale advanced by the Commission for its action was a statement that it believed the financial statements of the regulated utilities should reflect the "economic effect of rates" and that the failure to require accounting treatment identical to that adopted for rate purposes would result in "distortions of financial statements." (App. 3).

Texas Eastern and INGAA appealed Orders Nos. 505, 505-A and the Order Denying Rehearing and Reconsideration to the United States Court of Appeals for the District of Columbia Circuit primarily on the grounds that the rule would have a severe adverse impact on the utilities' ability to attract capital and that it served no regulatory purpose. Following oral argument, in which counsel for the Commission inferred that the accounting rule would have some beneficial impact on rates, the court, *sua sponte* directed the Commission to advise it whether Order No. 505 itself tended to affect rates and/or ratemaking in some circumstances and if so, in what circumstances and how (App. 97). In its reply, the Commission conceded: "In summary, Order No. 505 generally has no effect upon rates and/or ratemaking" (Se App. 103).

On September 18, 1975, the court reversed the Commission and remanded the record for further proceedings consistent with its memorandum opinion.

In such opinion the court stated that "we would be abdicating our judicial function were we to affirm on the basis of the materials before us. The Commission order under attack in this case provides only the most conclusory

justifications for the challenged rule . . ." (App. 99). The court instructed the Commission to prepare a new opinion if it intended to adhere to its previous orders. Specifically, the court directed the Commission to focus on and explain (1) the need for the accounting rule to preserve the ratemaking principle set forth in *Manufacturers Light and Heat Company,* 44 FPC 314 (1970), (2) the need for the accounting rule to maintain surveillance of public utility rates, (3) the need for the accounting rule to avoid distortion in utilities' financial statements, (4) why Commission "policy" to use the same procedure for ratemaking and accounting should apply in this case, and (5) whether the expected benefits of the rule outweighed the harm foreseen, as shown in comments filed by the utilities. The court cautioned that the regulation should be withdrawn unless the Commission could demonstrate how the proposed accounting rule was necessary to preserve the ratemaking function, why failure to amortize for accounting purposes would make the financial reports of regulated pipelines misleading, and whether benefits of the rule outweighed the harm.

On July 8, 1977 the Commission issued Order No. 505-B in which it adhered to its previous decision to require amortization on reacquisition of long-term debt but did not undertake to comply with the court's instructions.[5] It denied rehearing without further explanation. (App. 119-20).

On March 28, 1978, the Court of Appeals affirmed the Commission concluding, in a one page judgment, that it was

[5] The Commission conceded that its new accounting rule could have significant impact on the utilities' ability to raise capital, but argued that no actual detriment had been shown. It conceded that "the rate policy under *Manufacturers* could be followed regardless of the accounting" but concluded without explanation that "consistency" between accounting and ratemaking "facilitates the ratemaking process" and is necessary to "avoid financial reporting that obscures the economic realities of the ratemaking process" (App. 115-16).

"now of the view" that for reasons stated in Order No. 505-B the accounting rule expressed in Order Nos. 505, 505-A and 505-B was not arbitrary and capricious (App. 121-22).[6]

REASONS FOR GRANTING THE WRIT

The requested writ should be granted because

1. The accounting rule has a severe adverse impact on the ability of the utilities to attract capital with a resulting increase in cost to the consumers and is thus of extreme importance to them and to the consuming public which they serve.

2. There is no rational basis for the Commission's action. It arbitrarily exhalts form over substance requiring symmetry between ratemaking decisions and accounting practices without regard to the consequences.

3. In the final analysis the lower court abdicated its judicial review function.

THE FINANCIAL IMPACT

Attracting capital has been, for several years, and is now a major problem confronting utilities. By its nature, the service which the utilities provide is capital intensive. Utilities typically offer about 40% of the new bonds offered each year in the United States.[7] Long-term debt represents approximately 60% of the capitalization ratio of a typical gas transmission company. The amount and cost of new debt which a utility can issue is largely governed by its

[6] Mr. Justice Clark, formerly of the Supreme Court of the United States, sat by designation on the original panel which remanded the case. He was replaced on his death by Circuit Judge Robb. The other Judges on the panel were Judges Wright and MacKinnon.

[7] M. Farris & R. Sampson, *Public Utilities,* Chap. 13 (1973).

earnings, generally from the standpoint of investor confidence and specifically, from the standpoint of limitations customarily written into debt indentures. The accounting requirement of Order No. 505 thus has two significant adverse consequences for the utility and the consumer.

First, contrary to generally accepted accounting principles the utility is not permitted to reflect the entire gain in the year of the transaction. This has the effect of reducing interest coverages. It produces a lower return on equity and a lower earnings-per-share figure, thus making the securities of the utility less attractive vis-a-vis the securities of non-regulated businesses which reflect such gains currently. Patently the attraction of debt capital is enhanced by higher interest coverages. Artificially and arbitrarily requiring the utilities to report lower earnings, thus decreasing interest coverages, causes the utility's cost of debt capital, which is ultimately reflected in its rates, to be higher.

Secondly, under standard indenture provisions, a utility is limited to the amount of capital it can raise through debt financing. To the extent the utility is prohibited from issuing debt capital, it is forced to the issuance of equity securities, i.e., common stock. Equity financing involves a greater cost to the consumer than does debt financing.[8]

By limiting the utility's ability to issue debt capital and forcing a greater reliance on equity financing, the 505

[8] Interest associated with debt is tax deductible, while dividends associated with equity are taxable. It is the ultimate consumer who must provide the funds to pay dividends just as he must provide the funds to pay interest. Assuming a 50% tax rate, the utility must collect $2.00 in revenue from the consumer for each dollar it pays out in dividends, whereas it is only required to collect $1.00 in revenues for each dollar paid in interest. Further, since debt requirements must be satisfied first, equity funds carry a greater risk and thus are available only at a greater cost.

Orders threaten significant increases in the cost of capital to the utility and thus, ultimately, to the consumer. The Commission does not dispute this. Its answer is that no showing has been made that the rule has "in fact, caused such result" (App. 118).

The problems presented by Order No. 505 arise at a particularly crucial time. For the past several years, gains from debt reacquisition have been at peak levels because of the deep discounts at which the low interest-bearing debt issues of the 1950's and the 1960's have been traded (R. 498). On the other hand, utility demands for capital are at their peak and are continuing to increase.[9]

The significant adverse impact of the rule is illustrated from the fact that during 1974 and 1975, its effect was to require eleven major gas transmission companies and their affiliates to reflect artificially reduced earnings in a total amount of $54,281,000. This resulted in a reduction of borrowing capability for these two years in the total amount of approximately $224,000,000 (App. 117).[10] And to what end? Simply to achieve a sterile symmetry between the rate and accounting treatment of gains from reacquired securities.

The Commission's response to this substantial adverse impact is both cavalier and circular. It states in Order No. 505-B:

> "The fact that the effect of our rule on reported net income is significant lends support to our position that

[9] The American Gas Association forecasts that the investment of gas utilities alone through 2000 will exceed $200 billion in 1977 dollars. *Energy Analysis*, American Gas Association, March 3, 1978.

[10] This represents only the adverse impact on certain selected companies for the two years shown in the record. The total adverse impact has been substantially greater.

accounting and financial reporting needs to reflect the economic effects of the ratemaking processes" (App. 118).

It is not, of course, the economic effect of the ratemaking process which causes the significant financial impact. It is the rule itself.

THE ARBITRARINESS OF THE COMMISSION'S ACTION

The petitioners submit that the Commission's Orders disclose no "rational connection between the facts found and the choice made". *Burlington Truck Lines* v. *United* States, 371 U.S. 156, 168 (1962).

The adverse financial impact of the rule on the utilities and the fact that it does not affect the ratemaking process are undisputed. The Commission replied to the court that "Order No. 505 generally has no effect on rates and/or ratemaking" (see App. 103). In Order No. 505-B, it stated that "the rate policy under *Manufacturers* could be followed regardless of the accounting" (App. 115). It recognized the "critical needs of utilities for capital at reasonable costs" (App. 118). The threat of forcing higher cost equity financing is also recognized: "Our adherence to accounting for gains (losses) in a manner consistent with the economic realities of the ratemaking process lower the total borrowing capacity of some companies and could conceivably cause a company to resort to equity financing" (App. 118). Finally, the Commission conceded that the "effect of [amortization] on reported net income is significant" (App. 118).

On the other side of the scale, there is literally no more than the Commission's capricious insistence that accounting treatment track the method which it approved in

Manufacturers for computing debt cost in the overall rate of return determination.

The New York Public Service Commission explains the matter succinctly in its comments. It states:

> "Test year" regulation permits the regulatory agency to normalize such items for rate purposes if the test year amount as recorded on the books of account is not considered appropriate for regulating rates. *Many other items are not normalized. There is little justification for the FPC to adopt this improper accounting — it is not necessary.* The test year concept adjusted for known and anticipated changes is an adequate vehicle to accomplish for rate purposes what the FPC is apparently trying to accomplish by the proposed accounting. (App. 132).

The Commission itself says:

> Under various circumstances, accounting treatment and ratemaking treatment must necessarily diverge, but we do not believe that this is one of them (App. 93).

It offers no rational explanation why it does not believe this is one of them, however.[11] Its statement that "accounting and financial statements of regulated utilities should reflect the economic effects of rates" (App. 3) is meaningless. Nor is the claimed need for "disclosure" a rational basis for the rule. Full and complete disclosure can be pro-

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[11] Order No. 505-B discusses at length the necessity of having a Uniform System of Accounts and the matching of costs and revenues in the ratemaking process. Use is also made of the scare term "windfall profits" (see App. 115). This is apparently intended to create the impression that there is some rate implication involved here. There is none other than an inevitable increase in capital costs to the utilities with a resulting adverse impact on the consuming public they serve. Petitioners are not questioning the rate treatment of gains on reacquired securities. What petitioners are trying to avoid is an unnecessary Commission-induced increase in capital cost which can only have the effect of requiring increased rates.

vided without requiring artificially reduced earnings and handicapping the utilities in their efforts to attract capital.

Petitioners recognize the strictness of the standards involving judicial review of administrative orders. At the same time, however, the Commission's action must be rational to be valid. Here it is not. It serves no regulatory purpose.

THE LOWER COURT'S ABDICATION OF ITS REVIEW RESPONSIBILITIES

In its Memorandum Opinion of August 18, 1977, remanding the cases to the Commission, the court below stated:

> We are loathe to reverse the Federal Power Commission's judgment in a somewhat arcane area of accounting regulations for public utilities, especially when we are uncertain about the confusion which a reversal might create. *Yet we would be abdicating our judicial function were we to affirm on the basis of the materials before us.* (emphasis supplied, App. 99).[12]

The court directed the Commission to explain why the rule was necessary if it intended to adhere to it. It stated:

> We believe that an explanation is required when the FPC overrides both its own past practice and the thoroughly deliberated conclusion of the professional group most concerned with the accuracy of financial statements." (App. 106).

The court concluded:

> Nowhere does the Commission explain why the costs incurred are outweighed by the rule's benefits.

[12] Arbitrary Commission action is not supportable on the ground that reversal would create "confusion". Still there would be no confusion as a result of reversal here. Past years' earnings would simply be restated and realized gains transferred to equity (see APB Opinion 20, issued July, 1971).

> Of course, if the Commission can demonstrate that failure to amortize would make the financial reports misleading the fact that an accurate report would allow a company to issue less debt than would an inaccurate report is inconsequential. *See Appalachian Power Co.* v. *FPC, supra* 328 F.2d at 252. Similarly, if the Commission can explain how the accounting rule assists the Commission's efforts to carry out its assigned functions, balancing the assistance against the impact on the utilities' ability to raise capital should not be difficult. *If the Commission can meet neither of these prerequisites, this rule should be withdrawn.* (emphasis supplied, App. 108).

The rule was not withdrawn, however. Nor was the required explanation given. In Order No. 505-B, the Commission adhered to the amortization requirement, but, other than conceding it was not necessary for the preservation of the *Manufacturers'* rate principle, made no perceptible attempt to comply with the court's mandate. When the matter reached the court again, it affirmed without opinion. It merely recited in its judgment that it was "now of the view that the accounting rule promulgated by Order Nos. 505, 505-A and 505-B satisfies [the necessary and appropriate] standard" set forth in the Natural Gas Act for accounting rules, citing the same cases which it had cited in the decision remanding to the Commission (App. 122).[13]

Thus, in the final analysis, the lower court did abdicate its review function.

[13] *Burlington Truck Lines* v. *United States*, 371 U.S. 156, 168 (1962); *Bowman Transportation, Inc.* v. *Arkansas-Best Freight System, Inc.*, 419 U.S. 218, 286 (1974).

CONCLUSION

The arbitrary nature of the rule and its adverse impact on the utility's ability to attract capital warrant review by this Court. The Interstate Natural Gas Association of America and Texas Eastern Transmission Corporation therefore respectfully request this Court to grant this petition for writ of certiorari.

Respectfully submitted,

JEROME J. MCGRATH
JOHN H. CHEATHAM III
1660 L Street, N.W.
Washington, D. C. 20036

Attorneys for Interstate Natural Gas Association of America

JAMES W. MCCARTNEY
JUDY M. JOHNSON
2100 First City National Bank Bldg.
Houston, Texas 77002

Attorneys for Texas Eastern Transmission Corporation